## ARGUMENT



## STATUTES

# In the Supreme Court of the United States

OCTOBER TERM, 1925

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No. 864

THE UNITED STATES, APPELLANT

*v.*

THE PITTSBURGH & WEST VIRGINIA RAILWAY Company and the West Side Belt Railroad Company

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No. 865

THE PITTSBURGH & WEST VIRGINIA RAILWAY Company and the West Side Belt Railroad Company, Appellants

*v.*

THE UNITED STATES

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*APPEALS FROM THE COURT OF CLAIMS*

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## BRIEF FOR THE UNITED STATES

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### OPINION BELOW

The opinion of the Court of Claims (R. 16) is not yet reported.

## JURISDICTION

The judgment to be reviewed was entered May 4, 1925. (R. 22.) Application for appeal was filed by the United States July 17, 1925, and by the appellees for cross appeal July 21, 1925. (R. 22.) As no motion for new trial was made, the judgment was "entered" prior to May 13, 1925, the effective date of the Act of February 13, 1925, and the case is properly here on appeal under Sections 242 and 243 of the Judicial Code.

## STATEMENT

This suit was brought in the Court of Claims to recover part of the income taxes paid by the appellees on their net income for the year 1921, on the ground that they were entitled to be reimbursed by the United States.

The question presented is whether Federal income taxes for the year 1921 upon the net income of the railway companies for that year are taxes "assessed for the period of" Federal control within the meaning of the Federal Control Act and of the standard form of contract between the Director General and the railroads, because part of the income for the year 1921 consisted of compensation then paid for the use of railroad property by the United States during the period of Federal control.

The fundamental difference between the position of the United States and that of the appellees is obvious.

The United States contends that the period for which the income tax was assessed, and not the source of the income, is the controlling factor in the case. The appellees contend that the source of the income and not the year for which it was assessed is the important consideration.

The appellees are domestic railroad corporations owning and, except during the period of Federal control, operating lines of railroad. The Pittsburgh & West Virginia Railway Company owns all of the stock of the West Side Belt Railroad Company. (R. 11.) They have made consolidated income tax returns.

Their railroad properties were under Federal control from January 1, 1918, until March 1, 1920. (R. 11.)

During Federal control no agreement was made between the Director General and the appellees as to compensation to be made for the use of their properties; but in January, 1920, the Railroad Administration paid to the Pittsburgh & West Virginia Railway Company $250,000 on account of compensation for the use of the properties, and in 1921 a settlement agreement was made fixing the entire compensation at $1,820,000 (R. 12), and the sum of $1,570,000 was paid in 1921 as the balance of the compensation thus determined.

The settlement agreement of 1921 (made under authority of Section 202 of the Transportation Act of 1920, Chap. 91, 41 Stat. 456, 459) provided that the Director General assume towards these

corporations the obligations defined in Section 6 of the standard contract respecting taxes. (R. 6.)

Section 1 of the Federal Control Act (Act of March 21, 1918, Chap. 25, 40 Stat. 451) authorized the President to agree with carriers to pay compensation for the use of their property not exceeding an amount ascertained as provided in the Act, and provided that if such an agreement was made, it should contain, as to taxes, a provision as follows:

> Every such agreement shall provide that any Federal taxes under the Act of October third, nineteen hundred and seventeen, or Acts in addition thereto or in amendment thereof, commonly called war taxes, *assessed for the period of Federal control beginning January first, nineteen hundred and eighteen, or any part of such period,* shall be paid by the carrier out of its own funds, or shall be charged against or deducted from the just compensation; that other taxes assessed under Federal or any other governmental authority *for the period of Federal control or any part thereof,* either on the property used under such Federal control or on the right to operate as a carrier, or on the revenues or any part thereof derived from operation * * * shall be paid out of revenues derived from railway operations while under Federal control; * * *. (Italics ours.)

The standard contract, made pursuant to this statute, and which, by virtue of the settlement agreement, defines the rights of the parties to this case, provides (R. 8):

SECTION 6 (a). All taxes assessed under Federal or any other governmental authority for the period prior to January 1, 1918, including a proportionate part of any such tax assessed after December 31, 1917, for a period which includes any part of 1917 or preceding years, and unpaid on that date, all taxes commonly called war taxes which have been or may be assessed against the company under the act of Congress entitled "An act to provide revenue to defray war expenses and for other purposes," approved October 3, 1917, or under any act in addition thereto or in amendment thereof, and all taxes which have been or may be assessed on property under construction, and all assessments which have been or may be made for public improvements, chargeable under the accounting rules of the Commission in force December 31, 1917, to investment in road and equipment, shall be paid by the company; but upon the amount thus chargeable to investment interest shall be paid to the company during Federal control at the rate provided in paragraph (d) of section 7 hereof. Taxes assessed during construction or additions, betterments, and road extensions made by the company with the approval or by order of the Director General during Federal control, shall be considered a part of the cost of such additions, betterments, and extensions and shall, under the provisions of paragraph (d) of section 7 hereof, bear interest as a part of such cost from the date of the completion of such addi-

tions, betterments, or extensions. Assessments for public improvements which do not become a part of the property taken over shall bear interest from the date of the payment of such assessment.

(c) The Director General shall either pay out of revenues derived from railways operation during the period of Federal control *or shall save the company harmless from all taxes lawfully assessed under Federal or any other governmental authority for any part of said period on the property under such control,* or *on the right to operate as carrier,* or *on the revenues derived from operation, and all other taxes which under the accounting rules of the Commission in force December 31, 1917, are properly chargeable to "railway tax accruals,"* except the taxes and assessments for which provision is made in paragraph (a) of this section. The Director General shall pay or save the company harmless from the expense of all suits respecting the classes of taxes payable by him under this agreement. (R. 8–9.) (Italics ours.)

To ascertain the application of these provisions it is necessary to examine the Revenue Acts.

The Revenue Act approved September 8, 1916 (Chap. 463, 39 Stat. 756, 765), provided in Section 10:

> That there shall be levied, assessed, collected, and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation * * * organized in the United States, no

> matter how created or organized * * * a tax of two per centum upon such income * * *.

The Revenue Act of 1917, approved October 3, 1917 (Chap. 63, 40 Stat. 300, 302), in Title I, provides:

> SEC. 4. That in addition to the tax imposed by subdivision (a) of section ten of such Act of September eighth, nineteen hundred and sixteen, as amended by this Act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen and every calendar year thereafter, by every corporation * * * subject to the tax imposed by that subdivision of that section * * *.

When the Federal Control Act was passed the two tax Acts above set forth were in effect, and the tax which the carriers were expected to bear was the additional four per cent tax prescribed in the Act of 1917 and considered a war tax.

In 1919, after the passage of the Federal Control Act, the Act known as the Revenue Act of 1918 was passed (Chap. 18, 40 Stat. 1057, 1075–1076), which provided:

> SECTION 230 (a). That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

> (1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and
>
> (2) For each calendar year thereafter, 10 per centum of such excess amount.

In order to apply the Federal Control Act it was necessary, under the Revenue Act of 1918, to specify what part of the 12 per centum income tax for 1918 and the 10 per centum income tax for subsequent years should be considered as a war tax imposed by an amendment to the Act of October 3, 1917. Accordingly, in Section 230 (b) of the Revenue Act of 1918 the following provision appears (40 Stat. 1076):

> (b) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems while under Federal control, for the just compensation of their owners, and for other purposes," five-sixths of the tax imposed by paragraph (1) of subdivision (a) and four-fifths of the tax imposed by paragraph (2) of subdivision (a) shall be treated as levied by an Act in amendment of Title I of the Revenue Act of 1917.

In June, 1919, these corporations made a consolidated income and excess-profits tax return covering their income for the year 1918, showing a net taxable income of $20,943.33, on which the tax, at 12 per cent, was $2,513.20, which the appellees paid, and the Director General thereafter reimbursed the appellees in the sum of $418.86, which was one-

sixth of the tax and the equivalent of 2 per cent of the entire net taxable income of the carriers *from whatever source derived.* (R. 13, Finding VI.)

In May, 1920, appellees made a consolidated return of their incomes for the year 1919, showing a net taxable income from all sources for the year 1919 of $68,148.57, on which the tax, at 10 per cent, the 1919 rate, was $6,814.86, which amount was paid by the appellees to the Collector of Internal Revenue. The Director General thereupon reimbursed the appellees in the sum of $1,362.97, being one-fifth of the total tax and the equivalent of 2 per cent of the net taxable income.

In May, 1921, appellees made a consolidated income tax and excess-profits return covering their incomes for the year 1920, showing a net taxable income for 1920 from all sources of $531,667.22. (The return included in the gross income for the year 1920 the $250,000 paid by the Director General in 1920 on account of compensation.) The tax for 1920 was $53,166.72, which the carrier paid in 1921 to the Collector of Internal Revenue. After some disagreement, the Director General reimbursed the appellees in the sum of $1,772.22. One-fifth of the tax for 1920 (the equivalent of 2 per cent of the net taxable income from all sources) was $10,633.34; but as Federal control ended February 29, 1920, the two months of Federal control in 1920 constituted one-sixth of the year, and one-sixth of $10,633.34 was $1,772.22. (R. 14.)

It will be noted that in all these reimbursements, on account of Federal income taxes for the years 1918 and 1919 and two months of 1920, the Director General reimbursed the appellees for one-sixth or one-fifth, as the case might be, of the income and excess-profits taxes paid by the appellees and assessed for those years *without regard to the sources of the income or whether any part of it was derived from compensation for use by the United States of the railroad properties.*

The sum of $1,570,000, paid to the appellees by the Director General in 1921 in final settlement for compensation, was included by the appellees in their gross income for the year 1921 in making their consolidated return in 1922, covering income for the year 1921. The net taxable income of the appellees for 1921, taking into account their gross income from all sources and *the deductions to which they were entitled in 1921* in computing net income for that year, was $1,064,781.39. The tax at 10 per cent was $106,478.14, which was paid by the appellees to the Collector of Internal Revenue.

The Director General has not reimbursed the appellees for any part of the tax for the year 1921 thus paid. The Court of Claims granted the appellees judgment for $21,295.62, which was one-fifth of the tax on their entire net taxable income for the year 1921, being the equivalent of 2 per cent of their net taxable income. (R. 16.)

In auditing the appellees' return for the years 1918 and 1919, the Bureau of Internal Revenue ruled that of the compensation paid appellees in 1921, and by them treated as income for the year 1921, a part thereof should have been treated as income for the years 1918 and 1919—that is, income for the period of Federal control—with the result of increasing the appellee's income and excess-profits taxes for the years 1918 and 1919. No doubt the theory of the Bureau of Internal Revenue was that the compensation received in 1921 should be considered as accrued during the period of Federal control, when it was earned.

The appellees vigorously resisted this view, insisting that the amount of the compensation, in view of the failure of the Director General and the appellees to agree upon it, could not have been estimated during the period of Federal control and should not be treated as accrued income during that period, and that the compensation paid in 1921 was income for the year 1921 and taxable for that year at the 1921 rate, which was 10 per cent, as against a 12 per cent rate for the year 1918 and 10 per cent rate for the year 1919, and was subject to deductions which the appellees were entitled to take in 1921 as against their 1921 gross income. The appellees appealed the case to the committee of appeals and review, which finally sustained their position and held that the compensation paid in 1921

should be considered as income for that year. (Cumulative Bulletin 1–2, p. 67.)

What the appellees' five-sixths share of the tax for the year 1918, and four-fifths share of the tax for the year 1919 would have been if this compensation, paid in 1921, had been left where the Internal Revenue Bureau tried to place it, as income for the period of Federal control, does not appear.

### SPECIFICATION OF ERRORS TO BE URGED

The Court of Claims erred in holding that income taxes for the year 1921, assessed under the Revenue Act of 1921 on net income for the year 1921, were taxes assessed "for the period of Federal control," and erred in holding that the United States had agreed to indemnify the appellees against such taxes. So holding, the Court of Claims erred in granting judgment against the United States.

### SUMMARY OF ARGUMENT

Such liability as rests upon the United States to reimburse the appellees for taxes paid is founded upon a contract, to be construed in the light of the statutes authorizing it.

I. The contract, authorized and made, obligated the United States to reimburse the appellees for a part of their income taxes assessed for the period of Federal control, without regard to the source of the income taxed, or whether it consisted, in

whole or in part, of compensation paid by the United States for the use of their property.

An income tax assessed for the year 1921, on net income for that year, calculated and imposed under the Revenue Act of 1921, is not a tax assessed for the period of Federal control, and the fact that the gross income for 1921 included some compensation paid by the United States in that year is immaterial.

The provisions of the Revenue Act of 1921 show that Congress acted on the view that the Director General had assumed no obligation to reimburse the carriers for any part of their income taxes assessed for 1921 or later years.

The view that the obligation of the Director General with respect to income taxes of the carriers was determined with reference to the period for which the tax was assessed, and without regard to the source of the income, or whether it included compensation, was confirmed by practical construction in settlements made by the Director General with the appellees with respect to their income taxes for the years 1918, 1919, and 1920.

II. The delay in agreeing upon and paying the compensation to the appellees, and which resulted in a large part of the compensation being treated as income for 1921 and taxed for that year, presents no equitable consideration to justify ignoring the contract provision limiting the liability of the Director General for income taxes to those assessed for the period of Federal control.

The act of the appellees in resisting the attempt of the Commissioner of Internal Revenue to have the compensation paid in 1921 treated as income for the period of Federal control, and in insisting that it be treated as income for 1921, thus giving the appellees the benefit of a lower tax rate and of 1921 deductions, precludes the appellees from claiming they suffered by the delay. This record justifies the inference they have gained by it.

They should not be allowed to deal with one department of the Government on the basis that the compensation was income for the year 1921, and with another on the basis that the compensation paid in 1921 was income for the period of Federal control and subjected to a tax assessed for that period.

III. The cross-appeal is without merit.

ARGUMENT

Such liability as may rest on the United States to reimburse the appellees for any part of the income taxes levied upon and paid by them on their net income for the year 1921 is founded on contract.

The Federal Control Act did not impose such a liability. That Act contemplated that compensation for the use by the United States of the property of the railroads should be determined either by agreement or by judicial award, if the parties failed to agree, made in proceedings instituted in the Court of Claims. The Act did not attempt to define the compensation which should be awarded

in judicial proceedings, nor did it provide that the court in awarding the compensation should require the United States to bear any part of the income taxes which the carriers were required to pay on their net incomes derived from all sources; and if judicial proceedings were resorted to, the courts no doubt would award as compensation the full rental value or value of the use of the properties, leaving the railroad companies, as other taxpayers were required to do, to pay income taxes on such part of the compensation awarded as properly constituted income.

The provisions in the Federal Control Act relating to the payment of taxes are found in Section 1, which authorizes the President to make contracts fixing compensation.

The Act authorized the President to agree with the carriers to pay them as compensation "not exceeding" the amounts ascertained as provided in the Act. (Section 1.) It provided that if such agreement should be made, it should contain certain provisions relative to taxes.

In the present case, no such agreement was made until after Federal control ended, but it was made then in the form of a settlement agreement. That agreement adopted the provisions of the standard contract relating to taxes, so the inquiry here only involves an interpretation of the contract.

As the Federal Control Act supplemented by Section 230 (b) of the Revenue Act of 1918, specified

what such contract, if made, should contain on the subject of taxes, the contract must be treated as conforming to these statutes and construed accordingly, and the terms of the statutes therefore must be considered.

The United States contends (1) that under the terms of its contract with appellees, the income taxes here involved do not come within the definition of those taxes required to be borne by the Railroad Administration, because not assessed for the period of Federal control, and (2) that there are no equitable or other considerations presented which justify disregarding the terms of the statutes and of the contract.

## I

### THE INCOME TAX FOR 1921 IS NOT A TAX ASSESSED FOR THE PERIOD OF FEDERAL CONTROL, AND IS THEREFORE NOT ONE OF THE TAXES DESCRIBED BY THE FEDERAL CONTROL ACT AND THE STANDARD CONTRACT, MADE PURSUANT TO IT, AS ONE WHICH THE UNITED STATES IS REQUIRED TO BEAR

The Court of Claims failed to concentrate its attention on the language used in the Federal Control Act and in the contract made pursuant to it.

The Act provided (Section 1) that certain taxes "assessed * * * for the period of Federal control" should be borne by the Director General. Federal control ended February 29, 1920. A tax assessed for the year 1921 on the net income of

these corporations for the year 1921 was not a tax assessed "for the period of Federal control" merely because, in calculating the net income for 1921, there was taken into account as gross income for that year certain amounts then paid for the use of the railroads' property during Federal control. The Court of Claims has decided the case as if the statute and contract provided that the United States shall bear the so-called 2 per cent normal tax "on the income derived by the railway company as compensation for the use of its property during Federal control," without regard to the year in which the tax is assessed. The statute does not read that way. The Federal Control Act stated that the contract should provide that the tax to be borne by the United States should be a tax "assessed under Federal authority for the period of Federal control." The expressions used in this statute and the contract made pursuant to it are expressions common in statutes dealing with taxes and have well settled and definite legal significance. The phrases that a tax is assessed for a particular year or that a tax is a tax for a certain year are common terms in the law of taxation.

The income tax assessed for the year 1921 upon the net income of that year, calculated with all the deductions allowable for that year and at the rate specified by law for that year, is in no sense assessed by Federal authority for the period of

Federal control, when Federal control ended in 1920.

The record shows that the United States has already reimbursed these carriers for their one-sixth or one-fifth share of the income taxes assessed by Federal authority for the period of Federal control, without regard to the source of the income.

The decision of the Court of Claims and the contention of the appellees treat the Federal control Act and the contract made pursuant to it as if the phrase " for the period of Federal control " had been omitted.

A quotation from the statute, with this clause bracketed to indicate its omission, shows this to be so.

> That other taxes assessed under Federal or any other governmental authority [for the period of Federal control or any part thereof] either on the property used under such Federal control or on the right to operate as a carrier, or on the revenues or any part thereof derived from operation * * * shall be paid (etc.). (Section 1 of the Federal Control Act.)

The provision of Section 1 immediately preceding that above quoted, and which defined the taxes to be borne by the carriers, used the same expression, " assessed for the period of Federal control," and with the same significance.

A quotation from the standard contract on this subject, bracketing the clause which the Court of

Claims and the appellees ignore and treat as omitted, is as follows:

> The Director General shall either pay out of revenues derived from railway operations during the period of Federal control or shall save the company harmless from all taxes lawfully assessed under Federal or any other governmental authority [for any part of said period] on the property under such control, or on the right to operate as carrier, or on the revenues derived from operation (etc.).

If Congress had intended that the United States should reimburse the railroads for a share of their income taxes without regard to the year in which or for which they were assessed, merely because some items of compensation for the use of the roads, along with other items of gross income, entered into the calculation, it could have done so by omitting the words " assessed for the period of Federal control " and by adding other appropriate provisions on the subject.

The only contract authorized by the statute was a contract which limited the obligation of the United States to reimburse the carriers for a share of the income taxes assessed for the period of Federal control, and the contract actually made limits the obligation of the United States in that way; and neither statute nor contract, by their terms, impose an obligation on the United States to reimburse the railroads for taxes assessed for a later period.

Conclusive confirmation of this view of the statutory contract is found in the tax statutes themselves.

When the Federal Control Act was passed (March 21, 1918), there was one Revenue Act in effect (the Revenue Act of 1916), which imposed a tax of 2 per cent on corporate net income, and another statute (the Act of October 3, 1917), which imposed an additional tax of 4 per cent, enacted on account of the war and commonly known as a war tax.

The Federal Control Act treated the 4 per cent as a war tax, and stated that it and taxes imposed under amendments of the Act of October 3, 1917, should be borne by the carriers.

When the Revenue Act of 1918 (the Act of February 24, 1919) was passed, in lieu of the two taxes separately imposed by the 1916 and 1917 Acts, one of 2 per cent and one of 4 per cent, it substituted one tax of 12 per cent for 1918 and 10 per cent for later years. As a result, it became necessary to state in the Act what part of this tax of 12 per cent or 10 per cent should be considered as the successor of the 4 per cent war tax of 1917 and as a tax imposed by an amendment to the Act of October 3, 1917, so, in Section 230 of the Revenue Act of 1918, it was provided:

> SEC. 230 (a). That, in lieu of the taxes imposed by section 10 of the Revenue Act of 1916, as amended by the Revenue Act of

1917, and by section 4 of the Revenue Act of 1917, there shall be levied, collected, and paid for each taxable year upon the net income of every corporation a tax at the following rates:

(1) For the calendar year 1918, 12 per centum of the amount of the net income in excess of the credits provided in section 236; and

(2) For each calendar thereafter, 10 per centum of such excess amount.

(b) For the purposes of the Act approved March 21, 1918, entitled "An Act to provide for the operation of transportation systems while under Federal control, for the just compensation of their owners, and for other purposes," five-sixths of the tax imposed by paragraph (1) of subdivision (a) and four-fifths of the tax imposed by paragraph (2) of subdivision (a) shall be treated as levied by an Act in amendment of Title I of the Revenue Act of 1917.

This division of one-sixth or five-sixths, or one-fifth or four-fifths, by the terms of Section 230 (b) only applied to taxes "imposed" by paragraphs (1) and (2) of Section 230 (a) of the Act of February 24, 1919, and not to any tax which might be imposed by later statutes.

The Revenue Act of 1921 provided (chap. 136, 42 Stat. 227, 252):

SEC. 230. That, in lieu of the tax imposed by Section 230 of the Revenue Act of 1918, there shall be levied, collected, and paid for each taxable year upon the net income of

every corporation a tax at the following rates:

(a) For the calendar year 1921, 10 per centum of the amount of the net income in excess of the credits provided in section 236; and

(b) For each calendar year thereafter, 12½ per centum of such excess amount.

The income tax of the appellees for the year 1921 was a tax imposed by virtue of the Act of 1921, and the division of one-sixth and five-sixths, or one-fifth and four-fifths, as between the carriers and the United States, effected by Section 230 (b) of the Revenue Act of 1918, being limited to the tax imposed under that statute, did not operate upon the tax imposed by the Revenue Act of 1921. Indeed, the division effected by the 1918 Act was wholly unworkable as applied to taxes under the 1921 Act, for years subsequent to 1921, because the rate specified in the 1921 Act for those years was 12½ per cent, not divisible into one-fifth and four-fifths so as to place 2 per cent on the United States.

The Act of 1921 omitted any such provision as is found in Section 230 of the 1918 Act.

If Congress had considered or understood that an income tax for the year 1921, or later years, was a tax "assessed for the period of Federal control" within the meaning of the Federal Control Act and the standard contract made pursuant to it, merely because the net taxable income for 1921 and later years might have taken into account some compen-

sation derived from the use of the railroad property by the United States, it would, and should, have enacted in the 1921 Act a provision similar to that in Section 230(b) of the 1918 Act, to the effect that the four-fifths of the tax for 1921, imposed by Section 230 of the Act of 1921, should be considered a " war tax " for the purposes of the Federal Control Act, and that, with respect to taxes for later years, where the 12½ per cent rate was made to apply, 10½ per cent of the net income should represent the war tax for the purposes of the Federal Control Act. It failed to make any such provision, showing beyond question that it was not considered that an income tax for 1921, or later years, could, under any circumstances, be considered a tax for the period of Federal control or one any share of which the United States was required to reimburse the railroads for.

There is another consideration which further confirms the view that, with respect to income taxes, the period for which the tax was assessed and not the source of the income taxed was intended to be the test of the Director General's liability to reimburse the carriers.

In the first part of the clause of Section 1 of the Federal Control Act which deals with taxes, it was stated that the carriers should bear the 4 per cent income tax under the Act of October 3, 1917. The inference was, though it was not so stated, that the Director General would bear the income taxes on the carrier's income other than the war income

taxes. The next clause, stating expressly what taxes the Directeor General could agree to pay, seemed to limit his liability not only with respect to the period for which the taxes were assessed, but with respect to the nature of the tax, the provision being that the tax should be one on the property or on the right to operate as a carrier or on revenues derived from operation. This description did not fit an income tax on the carrier's income. The reference to taxes on revenues derived from operation evidently referred to the gross earnings taxes, such as are in force in Minnesota and California, and the carrier could not have any revenues derived from operation during Federal control; and as the Railroad Administration was not subject to an income tax under Federal income tax laws, it could not be subject to a tax on revenues derived from his operation, except gross earnings taxes above referred to.

The idea that the Director General should bear a share of the income tax on the carrier's net income was not clearly expressed. The passage of Section 230 (b) of the Revenue Act of 1918 followed, and this seemed to contemplate the payment by the Director General of a share of the income tax imposed on the carrier's net income under Federal revenue acts, *without regard to the source of the income,* the tax imposed by the Revenue Act of 1918 being a tax on income derived from all sources.

Considering the difficulties presented in attempting to divide an income tax according to the sources

from which the income was derived, and in view of the inferences to be derived from Section 1 of the Federal Control Act and the provisions of Section 230 (b) of the Revenue Act of 1918, all these doubts seem to have been resolved in favor of the carrier and in favor of the view that the law authorized the Director General to agree to pay one-sixth or one-fifth, as the case might be, of the entire income tax assessed for the period of Federal control on the carriers without regard to the source of the gross income entering into the calculation.

In this view of the matter, it resulted that the period for which the tax was assessed, and not the source of the income became the factor which determined the Director General's liability to reimburse the carriers. That principle was applied to the appellees, because the Director General reimbursed them for a share of the income taxes assessed against them for the period of Federal control without regard to the source of the income, and notwithstanding that in 1918 and 1919 no part of their income was derived from compensation paid by the United States for the use of their property. This view was adopted in the standard form of contract, which provided, in Section 6 (c), that the Director General should bear a share of the taxes on the carriers for the period of Federal control, which, under the accounting rules of the Interstate Commerce Commission, were properly chargeable as Railway Tax Accruals. The accounting rules

referred to (issued in 1914, effective July 1, 1914) provide:

> 532. RAILWAY TAX ACCRUALS.—This account shall include accruals for taxes of all kinds (including Federal income tax) relating to railway property (including floating equipment, if any), operations, and privileges, whether based upon the valuation of the property, amount of stocks and bonds issued or outstanding, gross or net earnings, dividends declared, number of passengers carried, quantity of freight transported, length of line operated or owned, rolling stock operated or owned, or other basis.

It was on this agreement relating to "railway tax accruals" which included Federal income taxes that the contract liability of the Director General to pay a share of Federal income taxes is based, and not on the view that the compensation was revenue derived from operation.

The practical construction of the statutes and of the standard contract applied by the Director General to all carriers, and acquiesced in by these appellees, in dealing with income taxes treated the period for which the tax was assessed as the essential factor in determining whether the Director General was required to reimburse the carriers, and ignored completely the source of the income as an element in determining the Director General's liability.

The appellees settled with the Director General on that basis his liability for income taxes for 1918, 1919, and two months of 1920.

The appellees seek now to have the source of the income treated as the test and to ignore the consideration as to whether the tax was one assessed for the period of Federal control.

## II

### THERE ARE NO EQUITABLE CONSIDERATIONS WHICH JUSTIFY IGNORING THE PLAIN TERMS OF THE CONTRACT

The literal terms of the statutes authorizing the contract and of the standard form of contract made pursuant to them preclude recovery by appellees. There could be no justification for ignoring the provisions of the contract and disregarding the provision that the taxes to be borne by the United States are taxes "assessed for the period of Federal control." The Court of Claims and the appellees, however, insist that because of the delay in paying the compensation, which resulted in its being included in the taxable income for a period after Federal control, there are equitable considerations which should induce the court to hold that the obligation of the United States with respect to a share of the income taxes of the appellees should follow the compensation paid for the use of their property, so that if in any year after Federal control an income tax is assessed on their net income, in the calculation of which income derived from compensation enters, the United States should reimburse them for a share of the tax.

This contention may seem plausible, but analyzed it is manifestly unsound.

In the present case the Commissioner of Internal Revenue first ruled that, although the final determination and the principal payment of compensation occurred in 1921, the amount constituted income to the appellees for the period of Federal control, as this compensation was for the use of their property during Federal control, and should be considered as having accrued in that period, and he, accordingly, allocated this compensation to the years 1918 and 1919, and the first two months of 1920. The rate in 1918 was 12 per cent and in 1919 and in 1920, 10 per cent.

By this adjustment, first made by the Internal Revenue Bureau, although the Director General would have borne part of the tax, the appellees would have paid, as their share of the tax, 10 per cent on part of the income derived as compensation and 8 per cent on the balance, and they would only have been entitled to take as deductions the deductions allowable in the years 1918, 1919, and 1920.

The appellees contested this decision of the Commissioner of Internal Revenue and obtained a decision from the committee of appeals and review, allocating this compensation paid in 1921, as income for that year, and their taxes were adjusted and paid accordingly. The rate for 1921 was 10 per cent. As a result, if the United States bears a share of the tax equal to 2 per cent of their net income for 1921, the railway companies will bear

8 per cent on the net income into the calculation of which the compensation of 1921 entered, instead of 10 per cent on part and 8 per cent on part, as would have been the case if the compensation were allocated to Federal control and subjected to income taxes assessed for the period of Federal control. In other words, by having this compensation allocated to the year 1921, instead of to the years of Federal control, *the appellees have succeeded in having a reduced rate applied in the calculation of that share of the income tax which they admittedly are required to pay.*

This is not all. Being treated as part of the gross income for 1921, the compensation was subject to the deductions in calculating net income allowable in 1921, such as losses, depreciation, interest, and other items suffered and deductible in that year.

The record discloses that deductions amounting to some half million dollars were allowed in arriving at the companies' net income for 1921. What the allowable deductions might have been for the years 1918, 1919, and 1920 do not appear, but the fact that the railway companies vigorously resisted the Government's attempt to have this compensation treated as income accrued during the period of Federal control justifies the inference that the appellees made a large saving in their share of the income tax by having the compensation treated as income for the year 1921. For all that appears in the record, even if the United States is not required to

bear one-fifth of the income tax for the year 1921, the appellees may be much better off than if compensation had been paid during Federal control, treated as income for that period, and subjected to a tax assessed for the period of Federal control, with an admitted obligation on the part of the United States to reimburse the appellees for a portion of it.

In other words, dealing with one department of the Government, the Treasury Department, the appellees, with the result of reducing their tax obligations, have procured a decision that the compensation for the use of their property during Federal control shall not be subjected to a tax assessed for the period of Federal control. Dealing with another department of the Government, the Railroad Administration, the appellees insist that they be treated as if the compensation had been paid during Federal control, and subjected to a tax assessed for the period of Federal control.

This process of whipsawing the Government does not seem to present equities which, in this case, should induce the Court to refrain from a literal application of the terms of the statute.

The delay in determining and paying the compensation has evidently operated to the appellees' advantage.

Appellees have insisted that by statute one-fifth of the tax on their net income was imposed, not on the corporation, but on the Director General, and that the appellees were not lawfully obliged to pay

the tax in the first instance. This is obviously unsound. It has already been shown that such obligation as rests on the United States as respects these taxes is based on a contract to indemnify or hold harmless the appellees.

The Court of Claims found, with respect to taxes under the Revenue Acts of 1916, 1917, and 1918, that—

> It was the custom for each carrier to return and pay the said two per cent normal tax, together with the taxes payable and bearable out of its own funds, upon the receipt of its just compensation, whereupon the United States, through the Director General of Railroads, duly credited the carrier to the extent of the said two per cent normal tax so paid. (R. 12.)

and it appears that this practice was followed in the case of these appellees. (R. 13–14; Findings VI, VII, VIII, and IX.)

The Court of Claims (R. 19) had the notion that the obligation of the United States to pay just compensation included an obligation to exempt that just compensation from Federal income taxes, which would follow the compensation into any year in which it was received and taxed. In this it was in error. The compensation, in so far as it was in the nature of rental for use, was as truly income as would have been the revenue derived by the carriers from operating their own property. Neither the Constitution nor any equitable consideration

required the United States to pay as just compensation the full rental value of the use of the property and at the same time exempt the recipient from such taxes as others were required to pay on their incomes.

The Court of Claims was also in error in saying that the compensation paid the appellees for 1921 was out of income to the Government derived from the operation of the appellees' railroads. There is no finding that the United States derived any net operating revenue from the operation of these railroads. For all that appears in the record, the compensation paid appellees may have come out of the appropriations aggregating $1,750,000,000 made during 1918, 1919, and 1920 for such purposes.

It has already been pointed out that the mention of taxes on revenues from operation had reference to gross earnings taxes levied by States and that the obligation of the Director General, as finally worked out in respect to income taxes paid by the carriers, is determined by the period for which the tax was assessed, and takes no account of the source of the income taxed, so that whether the compensation paid appellees in 1921 was " revenue from operation " is immaterial.

These considerations are not important, but they disclose the loose way in which the case was dealt with below and offer an explanation of the fact that the Court of Claims seems to have failed to

have given consideration to the exact terms of the Federal Control Act and the Revenue Acts and the contracts made under them, and ignored the contract that the income tax to be borne by the Director General was to be a share of taxes assessed for the period of Federal control, on income derived *from all sources,* and not an income tax assessed for some later period on that part of the income derived from compensation.

## III

### THE CROSS APPEAL IS WITHOUT MERIT

By a cross appeal, appellees question the refusal of the Court of Claims to allow them their attorneys' fees and expenses of prosecuting this suit. (R. 24, 25.)

If the Government is successful on its appeal, that will dispose of the cross appeal, but the claim is without merit in any event.

The prayer in the petition (R. 4) is for " such reasonable sum as the court might in its discretion fix for counsel fees and other expenses in connection with this suit." There is no other allegation on the subject and no finding by the Court of Claims.

The claim for attorney's fees is based on the following language in Section 6(c) of the standard contract (R. 9):

> The Director General shall pay or save the company harmless from the expense of all

suits respecting the classes of taxes payable by him under this agreement.

There were many cases in which the Director General questioned the validity of taxes and required the carrier to litigate the same. The contract was intended to save the carriers harmless from the expense of such litigation. It was never intended as a promise by the United States to pay the carriers attorneys' fees in suits brought against the United States.

It is submitted that the judgment against the United States should be reversed.

Respectfully submitted.

WILLIAM D. MITCHELL,
*Solicitor General.*

A. A. MCLAUGHLIN,
*General Solicitor, United States Railroad Administration.*

FEBRUARY, 1926.

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